No. 20,581

IN THE

United States Court of Appeals

For the Ninth Circuit

JOHN G. GROVES, Trustee,
Appellant,

vs.

FRESNO GUARANTEE SAVINGS AND LOAN ASSOCIATION,
Appellee.

On Appeal from the United States District Court for the Southern District of California, Northern Division

BRIEF FOR APPELLEE

KIMBLE, MACMICHAEL & RUNNER,
904 Guarantee Savings Building,
Fresno, California 93721,
Attorneys for Appellee.

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JURISDICTIONAL STATEMENT

The appeal in this case is from an order of the United States District Court for the Southern District of California, Northern Division, made in proceedings in bankruptcy. This Court has jurisdiction under Section 24a of the Bankruptcy Act (11 U.S.C. § 47a).

STATEMENT OF THE CASE

Park Terrace, a partnership, on September 30, 1964 filed a debtor's petition for an arrangement under Chapter XI of the Bankruptcy Act (R. 20). The

The judgment entered on the Referee's findings and conclusions enjoined appellee from commencing or continuing with proceedings to enforce the lien of its deed of trust until the further order of the court (R. 23-25), but decreed that:

> "pending the further order of this Court respondent shall continue as heretofore to manage and operate said property and to collect the rentals becoming due from the tenants of said property and respondent shall be responsible for the proper maintenance and operation of the premises comprising said property and shall be accountable to this Court for all rentals heretofore as well as hereafter collected by respondent from said tenants." (R. 24.)

Appellant petitioned the District Court for review of the Referee's order with respect to the rents (R. 27-28). The Honorable M. D. Crocker, United States District Judge, affirmed the Referee's order (R. 36-38) and the present appeal ensued.

QUESTION PRESENTED

Whether, by virtue of appellee's rights under its trust deed and actions taken by appellee before and after the bankruptcy proceedings began, appellee was entitled to retain the rents it had collected up to the time of the bankruptcy court's decision and to continue collecting the rents of the mortgaged property until the further order of the court, with the right to apply them as provided in the trust deed, subject to accountability for them to the court.

ARGUMENT

SUMMARY

The bankruptcy court's ruling that appellee was entitled under its trust deed to the rents of the mortgaged property, subject to accountability for them to the court, was in no way at odds with California law. The California cases hold that an assignment-of-rents clause in a trust deed is not self-executing on the trustor's default, and the beneficiary must do something more than make a demand on the trustor for the rents to perfect a claim to them. Appellee had started non-judicial foreclosure proceedings, had notified the tenants of the property to pay their rents to appellee, had taken over the actual operation of the property—and may be said to have had *de facto* possession of it, and was actually collecting the rents and holding them when the bankruptcy court made its ruling.

The order appealed from is in accord with prior decisions of this Court, in particular *Pollack v. Sampsell* (9th Cir. 1949) 174 F.2d 415. Appellee was assiduously pursuing its rights as beneficiary of the defaulted trust deed when the bankruptcy court's jurisdiction intervened, and persistently asserted its rights to the rents throughout the proceedings in bankruptcy.

There was no occasion for appellee to apply for a separate order sequestering the rents. Appellee itself was actually collecting and holding the rents. The court's orders with respect to the rents were in practical and legal effect sequestration orders.

On the face of the Referee's findings, appellant and the unsecured creditors he represents stood to lose nothing by the order appealed from. By its express terms appellee is accountable to the court for all the rents in question. Appellee claims only the right to apply the rents as provided in the trust deed, i.e., to costs of operating and maintaining the property while the rents were being collected and to the secured debt. If the property was worth more than the amount of the secured debt, the bankruptcy estate would necessarily receive the full benefit of the rents in the final accounting, which has yet to be made.

I. THE BANKRUPTCY COURT'S DECISION THAT APPELLEE WAS ENTITLED TO COLLECT AND RETAIN THE RENTS OF THE MORTGAGED PROPERTY, SUBJECT TO ACCOUNTABILITY FOR THEM TO THE COURT, WAS IN NO WAY INCONSISTENT WITH CALIFORNIA LAW.

We agree with appellant that federal courts of bankruptcy must apply state law in determining property rights, including rights under a trust deed. Appellant's concern on the point is ironical, however, considering that appellant's predecessor in interest, the debtor-bankrupt, invoked the jurisdiction and processes of the bankruptcy court with the object of preventing appellee from exercising rights which appellee had according to state law (see debtor's Petition for Order to Show Cause, etc., R. 2-4).

According to the California cases cited by appellant, *Childs Real Estate Co. v. Shelbourne Realty Co.* (1943) 23 Cal.2d 263, 143 P.2d 697, *Kinnison v. Guar-*

anty Liquidating Corp. (1941) 18 Cal.2d 256, 115 P. 2d 450, and *Malsman v. Brandler* (1964) 230 Cal.App. 2d 922, 41 Cal.Rptr. 438, the general rule is that a mortgagee[1] is not entitled to the rents of the mortgaged property until he obtains possession of it or has a receiver appointed. That this rule is subject to exceptions, however, is illustrated by *Title Guarantee & Trust Co. v. Monson* (1938) 11 Cal.2d 621, 627, 81 P.2d 944, where it was held that a beneficiary of a trust deed similar in its terms to the trust deed in the present case, who had demanded and was refused possession of the property after default, was entitled to the rents from the date he demanded possession. And to the same effect is *Mortgage Guaranty Co. v. Sampsell* (1942) 51 Cal.App.2d 180, 189-190, 124 P.2d 353.

Appellant insists that *Malsman v. Brandler* (1964) 230 Cal.App.2d 922, 41 Cal.Rptr. 438, *supra,* is controlling in the present case. There it was held that a trust deed essentially the same in its language as appellee's trust deed was not self-executing as an assignment of rents on default, and that the trustors were entitled to keep the rents they collected from the property up to the date the beneficiaries filed an action for appointment of a receiver. The similarity between *Malsman* and the present case begins and ends with the similarity of language in the trust deeds. In *Malsman* the beneficiaries merely notified the trustors

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[1]California follows the lien theory of mortgages and makes no distinction which is pertinent here between mortgages and trust deeds. West's Annotated California Codes, Civil Code § 2888. Therefore in this brief we will use the terms "mortgage" and "trust deed" and related terms interchangeably.

of the latters' default and demanded that any rents collected be delivered over, and did nothing further until they filed an action against the trustors, during which time the trustors continued to collect the rents. In the present case, the beneficiary—appellee—caused notice of default to be recorded in the official records of the county (R. 22); notified the tenants of the property that it was exercising its rights under the trust deed to collect the rents and that the tenants should make their rental payments accordingly (R. 22); and proceeded actually to collect the rents and in fact collected and now holds all the rents which are in dispute.

Moreover, although the Referee concluded as a matter of law that the debtor, and not appellee, was in possession of the property (R. 23),[2] it can reasonably be inferred from the record as a whole that appellee had *de facto* possession of the property at all times while the rents in dispute were being collected. This is indicated by the provision in the court's order of October 5, 1964 which provided that appellee might "continue collecting rentals becoming due from tenants of said premises" and would "be responsible for the proper maintenance and operation of said premises," (R. 17) and the terms of the order appealed from which provided that appellee should "continue as heretofore to manage and operate said

[2]This conclusion was based on a finding that the managing partner of the debtor partnership resided in one of the apartments on the property on and after September 30, 1964 and "was at all such times the agent of the partnership, overseeing the management of the said apartments" (R. 21-22).

property and to collect the rentals becoming due from the tenants of said property" and would "be responsible for the proper maintenance and operation of the premises comprising said property" (R. 24).

II. THE BANKRUPTCY COURT'S DECISION ON THE RENTS QUESTION WAS IN ACCORD WITH PRIOR DECISIONS OF THIS COURT.

The Court of Appeals for the Ninth Circuit has decided a number of the leading cases on the question of a mortgagee's rights to rents, issues and profits of the mortgaged property after default where bankruptcy of the mortgagor has intervened. Among them are *Pollack v. Sampsell* (1949) 174 F.2d 415; *Investors Syndicate v. Smith* (1939) 105 F.2d 611; *American Trust Co. v. England* (1936) 84 F.2d 352; and *In re Hotel St. James Co.* (1933) 65 F.2d 82. These and the other bankruptcy case authorities in point are collected in 4 Collier on Bankruptcy, 14th Edition, ¶ 70.16 [7], at pages 1044 to 1056.

In *American Trust Co. v. England, supra,* it was held that a petition by the mortgagee for sequestration of the rents, followed by a sequestration order, was the equivalent of taking possession of the mortgaged property by the mortgagee, with the effect that the mortgagee was held entitled to the rents from the time of filing the petition for sequestration.

Pollack v. Sampsell, supra, 174 F.2d 415, is particularly close to the present case in principle and on its facts. It concerned the rights of a beneficiary of Cali-

fornia trust deeds to the proceeds of a crop harvested from the mortgaged lands by the trustee in bankruptcy of the trustors. The beneficiary had started non-judicial foreclosure proceedings before the bankruptcy filing, and was prevented from going forward with the foreclosure by a restraining order of the bankruptcy court. The crop matured and was harvested and sold while the restraining order was in effect, and the net proceeds of the sale were impounded under an arrangement the beneficiary made with the trustee in bankruptcy, pending the court's determination of the beneficiary's rights thereto. The bankruptcy court eventually ruled that the beneficiary had no interest in the crop or its proceeds. In the meantime the beneficiary had been permitted to proceed with non-judicial foreclosure and a trustee's sale of the lands had ensued, resulting in a deficiency. On appeal, this Court reversed the bankruptcy court's decision, holding that the beneficiary was entitled to the proceeds of the crop by virtue of his rights under the trust deeds and the diligence he had exercised in pursuit of those rights. The court stated the applicable rule as follows:

> "[W]here the holder of the trust deed or mortgage has either by appropriate steps taken prior to bankruptcy, or by timely application to the bankruptcy court, actively undertaken to obtain the rents or profits of the real property for application upon the mortgage indebtedness, it is then the duty of the bankruptcy court to preserve the rents and profits for the holder of the trust deed or mortgage. These decisions [referring generally to decisions so holding] may be justified upon

the ground that in such cases the diligence of the mortgagee has demonstrated that he would probably have realized upon the rents or profits had bankruptcy not intervened." 174 F.2d at 419.

Another leading case in point is *Mortgage Loan Co. v. Livingston* (8th Cir. 1930) 45 F.2d 28. Judge Pope speaking for this Court in *Pollack v. Sampsell, supra,* 174 F.2d 415, said:

"The facts of this case are very similar to those in *Mortgage Loan Co. v. Livington,* 8 Cir., 45 F. 2d 28. In that case the controversy concerned the rents and issues of hotel property operated by a receiver in bankruptcy proceedings brought against the mortgagor of the hotel property. After default under the mortgage, the mortgagee initiated foreclosure by advertisement, and sale under power of sale was to have been held on June 29. A few days prior to that date, the petition in bankruptcy was filed and the court appointed a receiver and entered an order enjoining the foreclosure sale. The mortgagees asserted claim to the rents and issues collected by the receiver following the date when the mortgagees' sale was first advertised to be held. Subsequently the court granted leave to sell the property under the mortgage, and at the sale a deficiency was disclosed. The mortgage there described the real estate 'together with all * * * rents, issues and profits thereto belonging,' and provided that the trustee under the mortgage should be entitled to possession of the property directly or through a receiver in the event of default, and recited that he should have a right in that event to collect the revenue therefrom. When the foreclosure was restrained and the receiver appointed, counsel for

the mortgagees by letter advised the bankruptcy receiver of their claim to the rents and profits and requested the receiver to segregate the revenues from the hotel and to apply them to the payment of existing defaults under the mortgage. The receiver agreed that the hotel revenues should be kept separately but the mortgagees' petition for an order directing the receiver to pay them the revenues collected from the hotel for application upon the deficiency under the foreclosure sale, which exceeded that amount, was denied by the court except to the extent of the taxes and insurance on the property, the court holding that the mortgagees were not entitled to the rents and profits in question.

"Upon appeal the court held the mortgagees should have these rents. In an opinion the language of which we might well adopt here, the court said, 45 F. 2d at pages 32, 34: 'We are of the view that the mortgagees in effect intervened in the receivership proceedings in aid of their proceedings to foreclose, and this intervention operated to charge all of the net income arising from the operation of the property by the receiver with the lien of their mortgage. * * *

" 'To hold that the mortgagees had a legal right to these rents and issues under the provisions of their mortgage, but that they should be precluded from recovering same because they had not technically pursued a legal remedy is to overlook the fact that the property was in the control of a court of equity, and that equitable remedies commensurate with the legal rights of the parties should be available. To take from the mortgagees the property to which confessedly

they are entitled under the pledge provision of their mortgage, and transfer it to the unsecured creditors of the bankrupt, appeals to us as harsh, inequitable, and unwarranted.' " 174 F.2d 419-421.

III. THE BANKRUPTCY COURT CORRECTLY APPLIED EQUITABLE PRINCIPLES IN DECIDING THE CASE.

In answering appellant's argument that "the order below was inequitable and unjust," we cannot let stand without challenge the following assertions made in appellant's brief:

> "* * * Enforcement of the assignment of rents clause in Appellee's trust deed simply and effectively choked the last breath from the debtor in the Chapter XI proceedings.
>
> "Because Judge Crocker, by the modification of October 5, 1964 (R. 16-17), allowed Appellee all of the rents, the partnership was eventually adjudicated a bankrupt before the validity of Appellee's lien and the rents could be litigated (R. 22). This was manifestly inequitable and unnecessary in light of the excess value to Appellee's security. The general creditors (whose claims are reflected in the Claims Register which was brought up with the Record on Appeal) could never be induced to consent to any proposal of a debtor with no income, and a plan of arrangement became inconceivable." (Appellant's Opening Brief 11.)
>
> "* * * The Referee destroyed the unsecured creditors' opportunity for pecuniary return by the order granting Appellant all rents. Judge Crocker's modification of the temporary order

> destroyed the hope for an arrangement by denying the debtor any income." (Appellant's Opening Brief 12.)

These assertions are a gross distortion of the facts and are not supported by anything in the record. Moreover they are irrelevant; they are obviously spoken not by or for appellant, the trustee in bankruptcy, but by the ghost of the bankrupt partnership.

Appellant asserts that "to prove an equitable claim to rents, a mortgagee must show 'that the mortgaged property was worth less than the mortgage indebtedness,'" citing *In re Cigar Stores Realty Holdings, Inc.* (2d Cir. 1934) 69 F.2d 823 (Appellant's Opening Brief 11). The facts of the *Cigar Stores* case, however, were that the mortgagee there took no action and made no claim until after the trustee had sold the bankruptcy estate's equity in the property; then the mortgagee, without having even started a foreclosure proceeding, demanded that the trustee turn over the rents which he had collected from the property before making the sale. In holding that the mortgagee was not entitled to the rents the court said:

> "In any event, a condition precedent to the right of a mortgagee to rents collected is proof of a deficiency. * * * There is none here. And a mortgagee must account for rents received. * * * The fact that the property was sold for $50 in excess of all liens and charges of every nature indicates no deficiency and so no right to retain rents anyway on an accounting." (69 F.2d at 823.)

In contrast, the mortgagee in the present case—appellee—actively asserted its right to receive the rents

before the bankruptcy court issued its initial restraining order, continuously asserted that right throughout the bankruptcy proceedings, and actually collected and is holding the rents which are in issue. The mention in the *Cigar Stores* case of a mortgagee's duty to account for rents he receives from the mortgaged property has special significance for our case. Appellee has recognized from the beginning that it is accountable for the rents it has collected, and the order appealed from expressly makes appellee accountable to the court for those rents (R. 24). The "proof of deficiency," if there is a deficiency, will be presented when appellee makes its accounting.

We do not take issue with appellant's argument that federal as opposed to state equity doctrines should not be applied so as to alter state-created property rights. Appellee's case does not require us to do so. Nevertheless it is still true that bankruptcy proceedings are equitable in nature "and within the limits prescribed by the Bankruptcy Act and the special rules of practice prescribed by the Supreme Court are to be administered in accord with the general principles and practices of equity." *Pepper v. Litton* (1939) 308 U.S. 295, 303-308, 60 S.Ct. 238. It was therefore proper for the bankruptcy court to observe fundamental rules of equity in deciding the case.

The question of who should collect and hold the rents was presented to the bankruptcy court not as an independent question but in conjunction with the question whether the foreclosure proceedings appellee had commenced should be stayed. Appellee vigorously

contested the stay, contending that the fair market value of the property was less than the amount of the secured debt and the stay would only cause appellee further financial loss (Supplemental Record, Respondent's Answer to Petition for Order to Show Cause). The Referee was called upon to balance the equities between appellee and the unsecured creditors. On the one hand, a stay of enforcement of appellee's lien was desirable from the unsecured creditors' standpoint so that appellant, the trustee in bankruptcy, should have a fair opportunity to liquidate the bankruptcy estate's equity in the property. On the other hand, if the property proved to be worth less than the amount of the secured debt owed to appellee, the stay would be at the expense and risk of appellee. The unsecured creditors had everything to gain and nothing to lose by the stay, but the opposite was true of appellee. Appellee was then operating the property and collecting the rents by authority of the modified restraining order. By allowing appellee to remain in charge and to collect the rents, with the right to apply the net rents to the secured debt, subject to accountability to the court, the risk of loss to appellee by reason of the stay would be mitigated in some degree at least; and if the property proved to be worth more than the amount of the secured debt owed to appellee, it would make no difference to the unsecured creditors that appellee had received the rents, since every dollar of net rents applied to the secured debt would add another dollar to the value of the bankruptcy estate's equity in the property.

So the decision of the Referee staying the foreclosure proceedings but allowing appellee to collect the rents was an equitable one, made with due regard for the legitimate interests of both sides. A contrary decision, staying the foreclosure proceedings and denying appellee the rents, would have loaded the scales inequitably against appellee.

IV. THE EFFECT OF THE BANKRUPTCY COURT'S ORDERS WAS THE SAME AS IF A SPECIFIC SEQUESTRATION ORDER HAD BEEN MADE.

Appellant refers to the "brute fact" that appellee never moved to sequester the rents, and argues that this omission was fatal to appellee's case, citing *In re Humeston* (2d Cir. 1936) 83 F.2d 187, 188, and *Nash v. Onandaga Hotel Corp.* (2d Cir. 1944) 140 F.2d 209, 211 (Appellant's Opening Brief 11-12). In each of those cases the mortgagee had taken no affirmative step to claim the rents until after they were collected by the trustee or debtor, and then claimed them on the theory that the mortgage lien had somehow attached to them. In contrast, the mortgagees in *Pollack v. Sampsell* (9th Cir. 1949) 174 F.2d 415, and *Mortgage Loan Co. v. Livingston* (8th Cir. 1930) 45 F.2d 28, as in the present case, vigorously asserted their rights under the mortgage instrument both before and after the property came under the bankruptcy court's jurisdiction and ultimately prevailed although they made no application for a sequestration order.

Although insisting that appellee had no right to the rents because it did not move for a sequestration order (Appellant's Opening Brief 11-12, 16, 18), appellant argues that appellee would not have been entitled to a sequestration order anyway, because according to the Referee's findings the security for appellee's debt was more than adequate (Id. 17-18). The only authority cited for this proposition is *In re Cigar Stores Realty Holdings, Inc.* (2d Cir. 1934) 69 F.2d 823, a case we have already discussed,[3] where the mortgagee did nothing whatsoever until after the rents had been collected by the trustees in bankruptcy and did not at any time apply for a sequestration order. The case cannot by any stretch of imagination be read as holding or even suggesting that the mortgagee of property of a bankruptcy estate will not be entitled to an order sequestering the rents of the property unless he shows that the property is worth less than the mortgage indebtedness. What the opinion in the case does suggest is that where the rents of the mortgaged property have been sequestered, the mortgagee will be entitled to them only to the extent he can prove a deficiency. No more than this is claimed for appellee with respect to the rents which appellee has collected and for which it is accountable in the present case.

Appellant's contention that if the rents had been sequestered they would be available for payment of bankrupt administration expenses is not supported by any clear authority and will not stand up under

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[3]See page 14, *supra*.

analysis. The legal effect of sequestration is to make the rents subject to the lien of the mortgage. See *In re Kings County Real Estate Corp.* (2d Cir. 1933) 67 F.2d 895, 896. If sequestered, how could the rents be used for paying bankruptcy administration expenses, any more than the mortgaged property itself could be liquidated and used for this purpose?

Although not labeled as sequestration orders, the two orders (R. 17 and 24) which the bankruptcy court made with respect to the rents were in practical effect sequestration orders. Appellee was allowed to collect the rents until the further order of the court and was made accountable to the court for them, and their ultimate disposition was by clear implication left for later determination by the court (Ibid.). The rents were just as effectively sequestered as if the term "sequestration" had been used. There is no prescribed language or form for sequestration orders. Therefore there is no reason from the standpoint of either substance or form why the rent orders in question cannot be treated for all intents and purposes as sequestration orders.

V. ON THE FACE OF THE REFEREE'S FINDINGS, THE BANKRUPTCY ESTATE STOOD TO LOSE NOTHING BY THE ORDER APPEALED FROM, AND APPELLANT HAS NOT SHOWN THAT THE ESTATE ACTUALLY LOST ANYTHING BY THAT ORDER.

Nowhere in appellant's argument is any recognition given to the fact that by the express terms of the order appealed from appellee is accountable to the court for all the rents in dispute.[4] Appellee has never claimed to be entitled absolutely to these rents. On the contrary, appellee claims only the right to apply them as provided in the trust deed (R.—Respondent's Exhibit E), i.e., to costs and expenses incurred in maintaining and operating the property while the rents were being collected, and to the secured debt. Both the modified restraining order (R. 17) and the order appealed from (R. 24) charged appellee with responsibility for the "proper maintenance and operation of the premises comprising said property." In the ultimate accounting appellee should be allowed credit for reasonable and necessary expenditures made in discharging that responsibility. *Clayton v. Schultz* (1941) 18 Cal.2d 328, 334, 115 P.2d 446. In any event, the determination of whether appellee has fully accounted for the rents and has properly applied them

[4]Appellant at one stage seems to have overlooked this fact completely. In his notice of appeal (R. 39) it is stated that he "appeals . . . from that part only of the order . . . denying the bankrupt's petition for an order that respondent account for all rentals collected by it on property of the bankrupt." There was such a petition by the bankrupt, and appellee (respondent below) made an accounting in response to it, but the proceeding was dismissed on motion of appellant after the adjudication of bankruptcy (R.—Docket Entries, page 2, entries 1/8/65, 1/25/65 and 2/4/65, and page 3, entries 2/24/65).

will be made by the bankruptcy court, and appellant will have full opportunity to be heard in that proceeding.

Obviously it is the *net* rents, after appellee is allowed proper credit for reasonable and necessary expenditures made in maintaining and operating the property, which are at stake in this appeal. The essence of the bankruptcy court's decision which appellant is challenging is that the net rents should be available to be applied to the secured debt owed to appellee. But how, we ask, was appellant conceivably hurt by this decision if, as appellant's argument repeatedly stresses, the mortgaged property had a value of $167,000 greater than the amount of the secured debt owed to appellee, and the bankruptcy estate's equity in the property was worth $109,000? (see Appellant's Opening Brief 3, 6, 11, 12, 15 and 18). If the Referee's finding as to the value of the property is taken as conclusive, as appellant's argument apparently insists it must be, then the court may well wonder what this appeal is all about. Every dollar of the rents applied to the secured debt would add another dollar to the value of the estate's equity in the property. The practical result in terms of net asset values added to the estate would be the same as if appellant himself had received the rents.

As trustee in bankruptcy appellant has the duty to liquidate the assets of the estate with all reasonable dispatch. Bankruptcy Act Section 47a (1) (11 U.S.C. § 74). The bankruptcy court's order staying the enforcement of appellee's lien—made in conjunction with